

Stakeholders, Shareholders and Wealth Maximization

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ABSTRACT

This paper attempts reconciliation between the two somewhat extreme views espoused by the shareholder wealth maximization paradigm and the stakeholder theory. The stakeholder theory challenges the basic premise built into corporate finance theory, teaching and practice. Corporate finance theory, teaching and the typically recommended practice are all built on the premise that the primary goal of a corporation should be shareholder wealth value maximization. Extant theoretical and empirical research in financial economics also generally accept shareholder wealth maximization as the normative and ideal goal on which all business decisions should be based. This paradigm assumes that there are no externalities and all the participants engaged in transactions with the firm are voluntary players competing in free, fair and competitive markets. A very different view is offered by what is loosely called stakeholder theory. The stakeholder theory posits that the focus on shareholders and firm value is misplaced and managers should be concerned with all stakeholders of the firm. The paper attempts to address what is felt as a lack of dialogue between the two camps.

INTRODUCTION

Corporate finance theory, teaching and the typically recommended practice at least in the US are all built on the premise that the primary goal of a corporation should be the maximization of shareholder value. Extant theoretical and empirical research in financial economics also generally accepts shareholder wealth maximization as the normative and ideal goal on which all business decisions should be based. A quick survey of several corporate finance textbooks reveals this approach (Brealey and Myers (2003), Brigham and Ehrhardt (2002), Moyer, McGuigan and Kretlow (2003)). Jensen (2001) citing over 200 years of work in economics and finance, forcefully argues that maximizing the market value of the firm provides the “most purposeful, single-valued objective function,” which is necessary for efficient management of the firm. This paradigm assumes that there are no externalities and all the participants engaged in transactions with the firm are voluntary players competing in free, fair and competitive markets.

Shareholder wealth maximization is seen as the desirable goal not only from the shareholders' perspective, but also as for the society. Jensen (2001) argues that firm wealth maximization would lead to the maximization of society's wealth as well. Friedman's (1971) well known defense of this approach and the rejection of the arguments for social responsibility on the part of firms are widely quoted justifying this view.

A very different view is offered by what is loosely called stakeholder theory. The stakeholder theory posits that the focus on shareholders and firm value is misplaced and managers should be concerned with *all stakeholders* of the firm. While it is difficult to present a widely

accepted and well-defined form of the stakeholder theory, the essential message conveyed by nearly all of the stakeholder theorists is the rejection of the primacy of the shareholder. In other words, the stakeholder theory challenges the basic premise built into corporate finance theory, teaching and practice. While the theory has its origins in academic work relating to business ethics and business and society, it is finding much broader audience and a general, perhaps conditional, acceptance and respectability in business disciplines such as strategy. Many strategic management textbooks (e.g. Harrison (2003), Pearce and Robinson (2003), Pitts and Lei (2002)) suggest a broader view of the ideal corporate goal implied by the stakeholder theory. The stakeholder value approach is beginning to be seen as the desirable and preferred decision making model in not only strategic management, but also in other disciplines like marketing and management. While some finance textbooks attempt to reconcile the apparent conflict between the two approaches, most do not.

This paper is an attempt at reconciling the two somewhat extreme views espoused by the shareholder wealth maximization paradigm and the stakeholder theory. It aims to provide a fair and balanced review of the two approaches to corporate goal setting and their respective implications to business decision making. We also attempt to address what is felt as a lack of dialogue between the two camps. The paper is organized as follows. The first part provides a summary view of the shareholder wealth maximization approach, which we call the traditional finance paradigm. This is followed by a review of the current research and the salient parts of the stakeholder theory. The following section presents a summary of the critique of the stakeholder theory by two of the most eminent and perhaps the strongest critics of the theory, Michael Jensen (2001) and Elaine Sternberg (1999). This is followed by what we consider as our own insight into the stakeholder theory and our attempt at reconciliation between the two approaches. The last section provides summary and concluding comments.

THE FINANCE PARADIGM

The traditional finance paradigm puts the shareholder wealth maximization as the primary goal of corporate management. This paradigm is built upon the classic competitive markets assumption. Essentially, it is assumed that all participants who have transactions with a firm - employees, suppliers, customers, lenders, etc. - are seen as willing participants in free and competitive markets and are fully compensated at fair market prices for their services/supplies or get fairly valued products/services for the prices they pay. The shareholders are unique because they are residual claimants and they do not have prior explicit or implicit claims. They can add to their wealth only after satisfying all the prior claims of every other participant. They bear all the risk of failure and therefore it is only fair that they get the rewards. The model also assumes that there are no externalities or any harm or damage done to any non-participant in the transactions. Given these assumptions, shareholder wealth maximization is good for not only the shareholders and but also the society because the shareholders' wealth comes from wealth created by the firm after fully compensating everyone involved and the society for all the resources used.

It should be noted that while the traditional finance paradigm assumes competitive markets and no market imperfections, finance theory has evolved over time to include effects of some market imperfections. These, however, relate to imperfections in the financial markets or the transactions among shareholders, lenders, and managers. Two areas of extensive research and model development include agency relationships and information asymmetry. Except for some notable exceptions, there is little work relating to imperfections or inefficiencies relating to any other

participant such as employees or customers or suppliers. The exceptions relate to what has been loosely described as the *stakeholder theory* of capital structure. This strand of research pioneered by Titman and Wessels (1988) attempts to explain corporate capital structure and financing decisions in terms of relationships between the firm and special stakeholders like customers and suppliers (see Banerjee, Dasgupta and Kim (2008) for a recent example of this strand.) This research is still couched in terms of rational responses to problems caused by information asymmetry.

It should also be noted that the shareholder wealth maximization paradigm is seen as moral and ethical (Friedman (1971), Jensen (2001) and Sternberg (1999)). Any legal market transaction where all participants are free and willing participants is considered moral. This is seen as the foundation of the free market system. One interesting point may be worth mentioning. Jensen (2001) clearly stresses the society's wealth is maximized when the firm maximizes the total *market value of all financial claims including debt, preferred stock, and warrants* not just the value of shares. Nearly all other work, including Sternberg (1999), uses *shareholder wealth maximization* as the normative goal. The explanation, perhaps, for Jensen's expanded view is that shareholders may be able to expropriate wealth from bondholders and others who hold financial claims on the firm. In other words, here is a market imperfection that is recognized and internalized by Jensen. Should we consider "information asymmetry" between, say the firm's senior management and rank and file employees? How should a manager behave when setting prices or wages if she has market "power?"

THE STAKEHOLDER THEORY

Stakeholder theory has its academic roots in research related to business ethics and business and society. Freeman (1984) is regarded as the original proponent of the concept. Freeman argued that corporate management should look beyond shareholders and proposed a stakeholder perspective in managing the firm. Since then, a number of books and articles have been written on what is purported to be the stakeholder theory. There is little consensus on all the essential features of the theory including who the stakeholder is. Jones and Wicks (1999) have provided a good review of the current research and also attempt a synthesis of the extant research into a "convergent" theory. PFW (2003) give a critical account of what the theory is and is not. According to Freeman's (1984) original definition, a stakeholder is someone who can affect (impact) or is affected by the corporation. This definition has raised some hackles, especially, among the theory's critics. Jensen (2001) suggests that the Freeman definition would make even thieves and terrorists stakeholders. A more acceptable definition is someone who contributes to the value creation by the firm. Phillips (2003) proposes two classes of stakeholders - normative stakeholders referring to those who engage in transactions directly with the firm and derivative stakeholders referring to all others who might impact the firm or be affected by the firm. Firm's obligations are due only to the normative stakeholders, though the firm should be concerned with the derivative stakeholders (PFW (2003)). Kaler (2004) takes the view that firm should be concerned only with those stakeholders who contribute.

Jones and Wicks (1999) list the following as "essential premises" of the theory:

- Corporation has relationships with many stakeholders.
- The theory is concerned with the nature of the relationships, in terms of both processes and outcomes.
- Interests of all legitimate stakeholders have value.
- It is about managerial decision making.

- The theory is “explicitly and unabashedly moral.”

PFW (2003) add the following additional elements:

- It is a theory of organizational management and ethics.
- It is about managing for stakeholders, which involves attention beyond shareholder wealth maximization.
- It is consistent with “value maximization” though the created value is not just for shareholders.
- It is concerned with input in decision-making as well as with who gets the benefits.
- It does not maintain that all stakeholders should be treated equally, rather proposes a system of “meritocracy.”

Jones and Wicks (1999) attempt to develop a convergent stakeholder theory using the taxonomy suggested by Donaldson and Preston (1995) as the starting point. The three classes proposed by Donaldson and Preston are: instrumental, descriptive and normative. The instrumental version of the theory implies that certain actions by managers would result in certain outcomes. This could be stated as “managers should attend to stakeholders as a means to achieving other organizational goals such as profit or shareholder wealth maximization (PFW (2003)). The descriptive version is about the actual managers’ behavior and the normative version suggests that managers should behave in certain ways. Jones and Wicks further classify the normative version as ethics based and the instrumental and descriptive as social science based theories.

Current empirical studies of actual managerial behavior do not lend much support to the descriptive version (Jones and Wicks (1999), Margolis and Walsh (2003)). Jones and Wicks find the instrumental stakeholder theory more promising. PFW (2003) noted that a general version of this would be found acceptable even by those who hold shareholder wealth maximization to be the primary goal. The normative version emphasizes the “moral and ethical” arguments for the stakeholder perspective of looking at the firm and its objectives. This view would clearly reject the shareholder wealth maximization as the primary goal for the firm.

The Jones and Wicks attempt at developing a convergent theory has its critics. Trevino and Weaver (1999) seem to suggest that stakeholder theorists might very well work with other organizational theories (for example, even the agency theory approach suggested by Jensen and Meckling (1976)) instead of claiming a new theory. They suggest that what is available is a “stakeholder research tradition” rather than a stakeholder theory. The researchers share a common concern for organization stakeholder relationships. Freeman (1999) questions both the usefulness of the typology used and the suggested links between instrumental theory and ethics.

We adopt the following the key elements of the stakeholder theory from Jones and Wicks (1999), PFW (2003) and Freeman and Phillips (1999) and believe that these would be acceptable to most of its supporters. These include:

- Intrinsic worth in the claims of all legitimate stakeholders.
- No single objective function can do justice to the complexity of the firm.
- Rejection of the primacy of shareholders
- Compatibility of morality and capitalism.
- Firm as a nexus of relationships, not contracts.
- Rewards should be related to contribution.

It appears that an overriding concern for most of the stakeholder theorists is that the management of the firm may exclude the stakeholders other than shareholders from legitimate rewards as well as participation in key decisions concerning the future of the firm and their own future. PFW (2003) argue “an organization that is managed for stakeholders will distribute the fruits of organizational success (and failure) among all legitimate stakeholders.” A question seldom asked in the stakeholder literature is that would the stakeholders be willing to take on the fruits of failure. In other words, would the stakeholders (or which stakeholders) be willing to share the risk of the business and give up their explicit claims? The finance paradigm assumes that shareholders are the only ones willing to take the risk of failure and therefore have the legitimate claims to the residual value of the firm.

STERNBERG AND JENSEN CRITIQUE

Elaine Sternberg (1999), in a scathing attack, calls the stakeholder theory a mistaken doctrine and the most popular usage of the concept is “positively inimical” to responsible conduct on the part of managers and other stakeholders. Sternberg accepts two usages of stakeholding as commonplace and unobjectionable. These relate to motivation and the complexity of organizations. Sternberg, however, objects to the third usage- that the firm should be accountable to its stakeholders -, which implies, according to her “entitlements.” She argues that this usage of the concept “is fundamentally misguided, incapable of providing better corporate governance, business performance or business conduct.” She further suggests that this view of stakeholding is incompatible with business and undermines private property and accountability.

Here are some of the essential points made by Sternberg:

- Stakeholder theory is incompatible with substantive objectives, which are needed to run businesses effectively.
- Stakeholder objectives are unworkable as the nature of benefits due and the apportionment of benefits among stakeholders are not specified.
- Stakeholder theory is incompatible with corporate governance.
- The accountability doctrine suggested by the stakeholder theory – firms are accountable to the stakeholders, who are affected by or can affect the firm – is not justified.¹ Even when firm-specific skills are involved, it cannot be justified, and instead what may be called for is that such stakeholders should actually become stockholders.

Michael Jensen (2001) rejects most of the claims of the stakeholder theory on the grounds that the theory does not provide a clear organizational objective and does not specify how to make necessary tradeoff among the competing interests of the different stakeholders. Jensen concedes that a firm cannot maximize value if it ignores interests of its stakeholders. He proposes what he calls “enlightened value maximization” or its identical twin, the enlightened stakeholder theory. Long-term value maximization is specified as firm’s objective. This objective can, of course, be satisfied only with the cooperation and support of all relevant stakeholders. Management’s role is critical in motivating all the stakeholders and ensuring this cooperation. Jensen’s enlightened value

1 Phillips and Freeman (1999) have argued that residual risk is sometimes borne by employees or suppliers when their skills or expertise are extremely firm specific.

maximization or stakeholder theory resembles very closely the instrumental version of the stakeholder theory. Jensen makes the following points with respect to the conflict between the two theories:

- Purposeful behavior on the part of managers requires a single-valued objective function. This is provided by the finance paradigm, but not by the stakeholder theory.
- Value maximization makes the society better off.
- Stakeholder theory does not specify the tradeoffs required to be made to satisfy all the stakeholders.
- The market system of exchange with prices and property rights has contributed to enormous increases in human welfare and freedom of action. Stakeholder theory fails to recognize this and perhaps threatens the system.

Enlightened value maximization, in short, says that a firm cannot maximize value if it ignores or mistreats any important stakeholder group. By the same token, the enlightened stakeholder theory implies that firm value is the goal, but the processes and the audits suggested by the stakeholder theorists should form the basis of action towards motivating all the key stakeholders. Charron (2007) has also come out very strongly against the claims made by the stakeholder theorists. She views the entire stakeholder theory framework as an attempt at corporate control and needs to be resisted if the institution of corporation is to survive. Charron would not concede any moral basis for the arguments made in the stakeholder theory literature.

A COMPROMISE BETWEEN THE TWO THEORIES

While Charron, Jensen and Sternberg will convince most economists, it does not appear to convince ardent stakeholder theorists or for that matter of the broad general public. PFW (2003) while pleased that both Jensen and Sternberg accept the instrumental version of the theory, also feel that most of the characterization by the critics of the stakeholder theory are either unjust or are the result of misinterpretation of what the theory stands for. PFW attempt to answer the criticisms made by Jensen and Sternberg. However, careful reading of all the papers involved would give the distinct impression that the two groups are talking over the heads of each other. Clearly, given the assumptions of free exchange by voluntary players in a competitive market environment, most if not all of the arguments made by Jensen and Sternberg would be vindicated. Stakeholder theory supporters appear to have something else in mind. While competitive markets are taken for granted in the finance paradigm, stakeholder theorists seem to shy away from the concept. In other words, stakeholder theory implicitly assumes market imperfections and firms have power over the different stakeholders. The stakeholder theorists also seem to believe that in the real world, no stakeholder except perhaps stockholders would get a fair shake if he/she is left to market transactions.

The key question is to what extent the assumption of fair and competitive markets is valid for the different stakeholders. One wishes the stakeholder theorists would explicitly spell this out. In any case, the fear seems to be real and the important question that is not raised by either side is how valid are the assumptions of free and competitive markets. For examples do some firms have power over employees or suppliers as is commonly believed by many in the media in the case of companies like Wal-Mart? Do some firms have monopoly powers over customers? Of course, in order to justify the stakeholder view, one should not only see market failures or imperfections, but also lack of governmental regulations or legal restrictions on the firm.

CONCLUDING COMMENTS

This paper attempts to present the stakeholder theory view of the corporate goal and compares and contrasts the same with the traditional finance paradigm, which puts shareholder wealth maximization as the primary corporate goal. It appears that the proponents on either side of this academic debate fail to understand the other's perspective. This is mainly because each side starts from very different assumptions about the state of the markets and competition. The essential difference in between the stakeholder theory view and the finance paradigm can be summed up as follow: The finance paradigm assumes that the different stakeholders are not only free and voluntary players but are also able to get their fare reward or compensation because they interact with the firm through free and competitive markets and any market imperfection or failure is the exception rather than the rule. The stakeholder theorists, on the other hand, seem to go the other way and assume that firms cannot take free and competitive markets for granted and firms have to take specific actions to ensure fare rewards and compensation for all the stakeholders. It seems to implicitly assume that firms and shareholders possess powers over the other stakeholders. A dialogue between the two camps is possible only after we acknowledge this fundamental difference. Jensen's enlightened value maximization can be seen as a first step and a move towards recognizing that market failures that might cause harm to any stakeholders need to be addressed.

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